

**The Internal Revenue Service
Successfully Planned for and Executed
the Rate Reduction Credit Recovery Program**

December 2002

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 16, 2002

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Successfully
Planned for and Executed the Rate Reduction Credit Recovery
Program (Audit # 200240063)

This report presents the results of our review to determine if the Internal Revenue Service (IRS) effectively planned for and accurately calculated and posted additional Rate Reduction Credits (RRC) to affected taxpayers' accounts.

The Economic Growth and Tax Relief Reconciliation Act of 2001¹ provided for tax rebates to be issued based on the legislated reduction in tax rates. It also provided for a new credit, called the RRC, which could be claimed on Tax Year (TY) 2001 returns by eligible taxpayers that did not get the full benefit of the rebates. However, not all eligible taxpayers received this credit when their TY 2001 returns were processed because of a processing tolerance. To meet the intent of the original legislation, the IRS decided to identify those taxpayers that did not receive the additional credit during return processing and post the credit to their accounts. The program to accomplish this was called the RRC Recovery Program, which was the subject of our review.

Overall, the IRS successfully planned for and executed the RRC Recovery Program. The IRS posted credits totaling \$77 million to the accounts of approximately 1.6 million taxpayers, and all eligible taxpayers received the credit amounts to which they were entitled. The IRS prepared and followed a detailed action plan, developed and tested the computer extract programming, and prepared an explanation notice which was

¹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

mailed concurrently with the posting of the credits. The credits were posted in late September 2002, and approximately 1.5 million refund checks were issued at that time.²

Copies of this report are also being sent to the IRS managers who are affected by it. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

² The credits for the remaining taxpayers who did not receive refunds were applied to outstanding tax liabilities or other debts.

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Background

The Economic Growth and Tax Relief Reconciliation Act of 2001¹ included a reduction in tax rates beginning in Tax Year (TY) 2001 and provided for rebates to be issued as advance refunds of the tax rate reduction. This legislation also provided for a new credit called the Rate Reduction Credit (RRC) to be claimed on TY 2001 returns for those eligible taxpayers who did not get the full benefit of the rebates.

The RRC is a non-refundable² credit that can be claimed only on TY 2001 returns. A worksheet was included in the TY 2001 tax packages to enable taxpayers to determine if they were entitled to claim the credit. To help ensure that all taxpayers received the proper amount of the credit, the Internal Revenue Service (IRS) identified taxpayers during return processing that were entitled to the credit but did not claim it (or underclaimed it) on their TY 2001 returns. The IRS then added the credit to these taxpayers' returns and sent the taxpayers a notice informing them of the change.

While this process was generally effective during the 2002 Filing Season,³ some eligible taxpayers were not given the credit during return processing because of a processing tolerance. In the interest of efficient and economical operations, the IRS uses certain tolerances to reduce production time spent on smaller, less-productive cases. During our prior review we identified that some taxpayers were not receiving the credit during return processing because of these tolerances.

The IRS was also aware of this, and in order to meet the intent of the original legislation it decided to allow the RRC to these taxpayers as well. After the 2002 Filing Season was completed, the IRS identified the eligible taxpayers that did not receive the additional credit and posted the credit to

¹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

² Non-refundable credits may reduce the tax on the return to zero, but if the credits are more than the tax, then the excess is not refunded.

³ See audit report titled, *Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season* (Reference Number 2002-40-142, dated August 2002). The filing season is the time from January through April when the majority of all individual tax returns are filed and processed.

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their accounts. The credit was then refunded or applied to any outstanding tax balances or other outstanding debts. The program to accomplish this was called the RRC Recovery Program.

Our audit of the RRC Recovery Program was performed at the Wage and Investment Division's Submission Processing Headquarters Office in New Carrollton, Maryland, and at the Fresno Submission Processing Center. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Effectively Planned for and Accurately Calculated and Posted Additional Rate Reduction Credits to Affected Taxpayers' Accounts

The IRS successfully prepared for and executed the RRC Recovery Program. As of October 2002, credits totaling almost \$77 million were posted to the accounts of approximately 1.6 million taxpayers. The posting went as planned, and, aside from some minor problems, all eligible taxpayers received the credit amounts they were entitled to.

The preparations for posting the additional credits were comprehensive. The IRS prepared and followed a detailed action plan, with associated deliverable dates. The action plan included items necessary to the successful execution of the Program, including coordination with other IRS functions and other affected agencies, such as the Financial Management Service.⁴

The IRS also wrote programming requirements that would identify the affected taxpayers and compute the correct amount of additional credit. These requirements were then programmed and tested to ensure the extract worked as intended.

In addition, the IRS developed a new explanation notice for issuance concurrently with the credit postings in order to communicate to taxpayers the reason they qualify for an additional credit. The credits were posted to taxpayer accounts during the weeks of September 23, 2002, and

⁴ The Financial Management Service is the agency that actually issues tax refunds after certification by the IRS.

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September 30, 2002, and approximately 1.5 million refund checks were issued then.

The IRS will also post additional credits in December 2002, for taxpayers that filed an extension. The IRS made the decision to identify and post the majority of the credits after the 2002 Filing Season, after which approximately 95 percent of taxpayers had filed their returns. However, some taxpayers had approved extensions of time to file to October 15, 2002, and these taxpayers were not included in the initial extract.

Accordingly, the IRS is planning to perform another extract in December 2002 to identify any remaining taxpayers who are entitled to additional credits. We did not review this final extract since it is essentially identical to the one made during September 2002. Currently, the IRS estimates fewer than 40,000 taxpayers will receive a credit in the final extract.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) effectively planned for and accurately calculated and posted additional Rate Reduction Credits (RRC) to affected taxpayers' accounts.

To accomplish our objective, we:

- I. Evaluated whether the IRS programming preparations were sufficient to reasonably ensure an accurate RRC was posted to all affected taxpayer accounts with a minimum of adverse effects.
 - A. We determined if the planned extract logic appeared to meet the requirements for identifying affected taxpayers and for computing the correct amount of credit. We obtained and reviewed the programming documentation and interviewed the programmers and other IRS personnel involved with the extract.
 - B. We evaluated the testing performed on the computer programming by interviewing the personnel responsible for the testing and by reviewing the raw test results documentation.
 - C. We evaluated the overall action plan prepared for the program to determine if all major issues had been addressed and if the program was on schedule.
- II. Evaluated whether the computer extract posted the correct credit amount to the required accounts and whether any adverse conditions were caused.
 - A. We determined if the actual number of taxpayers receiving the additional credit matched the estimated number.
 - B. We determined if the accounts being adjusted should have received the credit and if the credit amount was correct. We selected a statistically valid random sample of 500 accounts from the approximately 1.6 million accounts that received an additional credit. We selected every 3,200th account from the population of 1.6 million, and the sample size was sufficient to meet a 99 percent confidence level, a precision of plus or minus 2 percent, and a 1 percent expected error rate. We reviewed these accounts using the Integrated Data Retrieval System¹ (IDRS) to determine if the taxpayers were entitled to the credit and if the posted credit amounts were correct. We also reviewed the accounts to identify possible adverse account conditions caused by the posting of the credits.

¹ The IDRS is the IRS computer system used to research and adjust taxpayer accounts.

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- C. We determined if the IRS had identified all affected taxpayers. We used data files created during our prior review of the processing of the RRC during the 2002 Filing Season.² These files contained all taxpayers that filed a return with an RRC discrepancy of any amount during processing cycles 200206 through 200217 of the 2002 Filing Season. We queried these files to identify all taxpayers that would have been eligible for an additional RRC based on the return filed. We matched the identified taxpayers to the IRS production computer extract file and reviewed a random interval sample of 50 accounts from the approximately 44,000 (4 percent) that did not match (i.e., that were on our file but not on the IRS' file). We selected a random interval sample because we considered the rate of mismatch of approximately 4 percent to not be significant enough to warrant a statistically valid sample.

² See audit report titled, *Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season* (Reference Number 2002-40-142, dated August 2002). The filing season is the time from January through April when the majority of all individual tax returns are filed and processed.

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Appendix II

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Stanley Rinehart, Director

Richard Calderon, Audit Manager

Charles Ekunwe, Senior Auditor

Steven Stephens, Senior Auditor

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Appendix III

Report Distribution List

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